BEFORE THE STATE TAX APPEAL BOARD

OF THE STATE OF MONTANA

---

| | | |
|---|---|---|
| JAMES & ANNETTE LOFLIN,<br><br>Appellant,<br><br>-vs-<br><br>THE DEPARTMENT OF REVENUE OF THE STATE OF MONTANA,<br><br>Respondent. | ) | DOCKET NO.: IT-1998-3<br><br>FACTUAL BACKGROUND, CONCLUSIONS OF LAW, ORDER and OPPORTUNITY FOR JUDICIAL REVIEW |

---

The above-entitled appeal came on regularly for hearing on the 15th day of July, 1999, in the City of Billings, Montana, pursuant to the order of the State Tax Appeal Board of the State of Montana (the Board). The notice of said hearing was duly given as required by law setting the cause for hearing. The taxpayers, represented by W. Scott Green, attorney, and James T. Loflin, presented testimony in support of the appeal. The Department of Revenue (DOR), represented by Mike Adkins, tax counsel, and Edwina Rose, tax program supervisor of the Income Tax Division, presented testimony in opposition thereto. At this time and place, testimony was presented, and exhibits were received. The Board allowed the record to remain open for a period of time for the purpose of receiving post-

hearing submissions from the parties. Having received the post-hearing submissions in a timely fashion, the Board then took the cause under advisement; and the Board having fully considered the testimony, exhibits, post-hearing submissions, and all things and matters presented to it for its consideration by all parties in the Docket, and being well and fully advised in the premises, concludes as follows:

## FACTUAL BACKGROUND

1. Due, proper and sufficient notice was given of this matter, the hearing hereon, and of the time and place of said hearing. All parties were afforded opportunity to present evidence, oral and documentary.

2. The issue under appeal is a refund claimed on an amended Montana individual income tax return for taxable year 1996 in the amount of $5,765.

## TAXPAYERS' CONTENTIONS

Mr. Loflin testified that he became a Montana resident on January 6, 1994. Prior to that date, he was a resident of Long Island, New York for two and one half years. Prior to that, he was a resident of Lexington, South Carolina for approximately 14 years.

New York and South Carolina both have a state income tax. The issue in dispute rose out of an interest

that Mr. Loflin had in a limited partnership, Roney Plaza Associates, Ltd. For tax year 1996, there was a $232,764 gain on the disposition of assets of Roney Plaza (Taxpayer's Exhibit 4, page 7 – Schedule K-1 – Shareholder's Share of Income, Credits and Deductions, etc.) This gain was realized as a result of the partnership conveying that property to one of its creditors in lieu of foreclosure. The property wasn't actually sold. Rather, it was conveyed to a creditor, the mortgage holder.

Mr. Loflin acquired an ownership interest in Roney Plaza, at a cost of $65,000, at the urging of his stockbroker "in 1983 in regards to buying into this partnership as a tax shelter (to offset personal income, or to defer taxes, in South Carolina and New York). I purchased one half of a share." (James Loflin testimony, State Tax Appeal Board hearing, July 15, 1999). The payment of $65,000 was spread over a period of approximately five years, starting in 1983. Mr. Loflin stated that he has not received any return on this investment. Mr. Loflin did receive "tax write-offs on my South Carolina tax return and my New York tax return in 1987. . .I did get a little bit, I think around $6,788, in Montana" (James Loflin testimony, State Tax Appeal Board hearing, July 15, 1999) as a result of owning this

interest. He testified he did not receive any distribution of cash or property upon the distribution of Roney Plaza in 1996. He characterized the $232,764 net gain referenced on the 1996 Schedule K-1 as a "phantom income. It was a recovery of the partnership's write-offs and this was my portion of that write-off over the years that we had the partnership. And, of course, I never was able to use that kind of deduction because I never had that kind of income over the years. But, it was purely a phantom write-off after they had conveyed it over to the creditor. They had to recapture their depreciation." (James Loflin testimony, State Tax Appeal Board hearing, July 15, 1999). Only deductions taken in South Carolina and New York would offset the reporting of this "phantom income" to Montana. Regarding the losses, "They represented my initial investments. My losses that I never recaptured, to the tune of about $65,000 and I never saw that come back to me, but beyond the $65,000, it was not real money." (James Loflin testimony, State Tax Appeal Board hearing, July 15, 1999).

Montana returns were filed in 1994 and 1995. $6,788 total losses were reported for both years from the Roney Plaza on the Montana returns.

The taxpayers' post-hearing brief outlines the history

of the appeal:

The taxpayers are residents of the State of Montana and timely filed their original 1996 Income Tax Return with the State of Montana. The taxpayers became residents of the State of Montana during the year 1994. Prior to the year 1994 and at all relevant times prior to 1994, the taxpayers were residents of the State of New York and South Carolina.

On the taxpayers' 1996 Montana Individual Income Tax Return, the taxpayers claimed $232,764.00 of capital gain on line 10 of the return from the disposition of assets of Roney Plaza Associates, Ltd. On line 12 of the tax return, $162,520.00 of loss was claimed pursuant to Form 8582. $156,135.00 was as a result of Roney Plaza Associates, Ltd. A K-1 was issued to the taxpayers and attached to the relevant returns.

As a result of the $232,764.00 capital gain and the $162,520.00 claimed on line 12 of the original return, there was a net $70,244.00 gain as a result of the K-1 received by the taxpayer on Roney Plaza Associates, Ltd. Upon review of that K-1, it is revealed that there is a negative capital account at the beginning of the year of $226,682.00 along with miscellaneous losses and other gains. In any event, no proceeds were received by the taxpayers as a result of the disposition of the Roney Plaza Associates assets. As a result of the difference between line 10, capital gains, and line 12, Schedule E, losses, there is resulting income of $70,244.00.

On or about May 28, 1997, Plaintiffs' tax attorney, after review of the Montana law, filed an amended return for the State of Montana individual income tax for the year 1996. The amended return reduced the gain as a result of the disposition of Roney Plaza Associates, Ltd. to the extent the losses previously taken by the taxpayers had not reduced the Montana income tax. This was accomplished by computing the amount of benefit the taxpayers had received as a result of the losses of Roney Plaza Associates, Ltd. against Montana income tax and subtracting that amount from the $70,244.00 gain as a result of the disposition of the Roney Plaza Associates, Ltd. The tax benefits the taxpayers received as a result of previous losses in the State of Montana were deductions in the amount of $1,676.00 in the year 1994 and $5,112.00 in the year 1995. The sum

of these two numbers, $6,788.00, was subtracted from the $70,244.00 gain, thereby resulting in a net change decrease set forth in Column A, line 3, of the Amended Montana Individual Tax Return for the year 1996 in the amount of $63,456.00. This amount is the amount of the gain which was the result of losses taken prior to the taxpayer becoming a resident of the State of Montana.

On December 3, 1997, the Department of Revenue, Income and Miscellaneous Tax Division, denied the taxpayers' requested refund as a result of the Amended Tax Return and this appeal ensued. . . . As a result of this change, there is a refund due the taxpayer in the amount of $5,765.00.

On the taxpayers' amended 1996 Montana Individual Income Tax Return, the taxpayers attached a statement setting forth the purpose and legal analysis of the position taken on the amended return. That attachment stated as follows:

ATTACHMENT A

This amended return is being filed with the noted changes. The reason for the change is Montana Code Annotated Title 15, Chapter 30, Part 1.

MCA, Section 15-30-111. Adjusted gross income.
(2) Notwithstanding the provisions of the Federal Internal Revenue Code of 1954, as labeled or amended, adjusted gross income does not include the following, which are exempt from taxation under this chapter:
(k) Recovery during the tax year of any amount deducted in any prior tax year to the extent that the recovered amount did not reduce the taxpayers' Montana income tax in the year deducted.

This amendment is a result of the K-1 from Roney Plaza Associates, Ltd. Attached hereto are copies of the Montana 1996, 1995 and 1994 Montana Individual Income Tax Returns. The taxpayers were not residents of and did not earn any income in the State of Montana prior to 1994. Upon review of the 1994 Montana Individual Income Tax Return, it can be

determined that the tax benefit of the limited partnership of Roney Plaza Associates, Ltd. was $1,676.00 The tax benefit for the limited partnership, Roney Plaza Associates, Ltd. for the year 1995 was $5,112.00. The sum of these two amounts is what reduced the taxpayers' Montana income tax returns in previous years. The reduction that is computed is as follows:

$1,676.00
+ 5,112.00

$ 6,788.00

The change to the amended return was filed as follows:

| | | |
|---|---|---|
| Line 10 | | $232,764.00 |
| Line 12 | - | $162,520.00 |
| | | $ 70,244.00 |

$70,244.00 minus $6,788.00 equals $63,456.00 which is the net change decrease set forth in Column A, Line 3 on the Amended Montana Individual Income Tax return.

As a result of this change, there is a refund due the taxpayer in the amount of $5,765.00.

The taxpayers take issue with the DOR position at hearing that the Tax Benefit Rule under Section 30-15-111(2) (k) is strictly limited to itemized deductions. The taxpayers argue that they received no Montana tax benefits from the deductions taken while they were residents of other states. The taxpayers testified that they were residents of the states of New York and South Carolina and deducted against their state income tax the deductions during the period of time when they were residents of those states and, therefore, received no tax benefits during those years.

## DEPARTMENT OF REVENUE'S CONTENTIONS

The taxpayers timely filed a Montana individual income tax return for taxable year 1996 as full-time residents on April 14, 1997, reporting a tax due of $5,150. The taxpayers moved to Montana in 1994 from New York. An amended Montana individual income tax return was subsequently received from the Loflins on May 29, 1997. The second return sought to recapture the 1994 and 1995 tax benefit the taxpayer had realized from the New York-based Roney Plaza Associates, Ltd. Such benefits amounts were applied to offset the gain they had realized from the sale of the partnership in 1996, i.e., $232,764; (line 6, Schedule K-1, Roney Plaza Associates, Ltd., c/o The Related Companies, 625 Madison Avenue, New York, NY 10022). The loss amounts reported attributable to the partnership had been $156,135. The total loss amount from rents, royalties, partnerships, estates, trusts, etc., reported on line 12 of the original 1996 return had been $162,520. Thus, subtracting the line 12 total losses from the line 10 capital gain reported on the original return yielded income of $70,603.

The net effect of the amended return was to claim a reduction of income, (Line 3, Column A) of $63,456. The taxpayers assert this fairly represents the reduction in

gain resulting from the disposition of the foreign limited partnership to the degree of losses previously claimed by them which had not correspondingly decreased Montana income tax. Deductions in the amount of $1,676 and $5,112 for tax years 1994 and 1995, respectively, were claimed as representing bona fide losses in Montana, and subtracted from the capital gain previously reported of $70,244, resulting in the net decrease amount reported on Line 3, Column A. The taxpayer did not filed an amended return in New York or South Carolina.

The DOR denied the taxpayers request for refund claimed on the amended return, stating:

> As a full-year resident of Montana you were taxed on all income earned in 1996, regardless of where you earned it. The income from Roney Plaza Associates, Ltd., is partnership income. Partnership income is your share of any partnership income and deductions that is included in federal adjusted gross income. Partnership income is one of two types, passive or nonpassive. The type of income depends upon whether or not you materially participate in the activities of the partnership. If the income is passive, you are required to fill out Form 8582 to determine the loss you are allowed from your passive activity. Your share of the partnership income includes income, capital gain, and deductions from the partnership whether or not you actually received it . . .

The DOR contends that the controlling statute in this matter is Section 15-30-111 (2) (k), MCA. Subsection (1)

of this statute defines Montana adjusted gross income as a taxpayer's federal adjusted gross income as defined in Section 62 of the Internal Revenue Code of 1954, as that section may be labeled or amended, subject to specific enumerated additions or exclusions described in the statute itself.

Subsection (2) (k) states:

> (2) Notwithstanding the provisions of the federal Internal Revenue Code of 1954, as labeled or amended, adjusted gross income does not include the following which are exempt from taxation under this chapter:
>
> (k) the recovery during the tax year of any amount deducted in any prior tax year to the extent that the recovered amount did not reduce the taxpayer's Montana income tax in the year deducted. (Emphasis supplied).

The DOR refers to this subsection as the "tax benefit rule." It contends that the phrase "amount deducted in any previous tax year" must be construed to apply only the Montana income tax deductions. (The taxpayer argues that this phrase can be construed to include prior federal income tax deductions claimed by them in previous years.) At the hearing before this Board, the DOR cited the following examples:

> A taxpayer's Federal income taxes paid or withheld from the current year wages was $10,000. If the taxpayer uses that $10,000 as an itemized deduction and a refund is received from federal government, that income is reportable in the following year.

> Also, medical expenses that were claimed as unreimbursable by a taxpayer's insurance program, and the taxpayer subsequently receives payment by insurance company, this payment is reportable as income in Montana since it was claimed as a deduction in a prior year.

The tax benefit rule establishes that, if an amount deducted in a prior tax year is recovered, the recovered amount must be reported to the extent that it reduced a taxpayer's Montana income tax liability in the year it was deducted. A taxpayer is not obligated to report any portion of a recovered deduction that had not actually reduced his or her Montana income tax in the year of the deduction. Conversely, any recovered amount of deduction would be reported as income in the subsequent year in which the payment had been received.

In applying the tax benefit rule, the DOR has used a two-prong test. The two conditions evident from the statute are that the item has been deducted in a prior year, and that it has benefited the taxpayer by reducing his or her Montana income tax, i.e., a deduction had to have been taken in Montana and that deduction had to have benefited the taxpayer by reducing the taxpayer's Montana tax obligation. The taxpayer's returns on record met the requirement in the years in which he filed, 1994 and 1995. He correctly reported his income and losses the same as he

did for federal purposes. However, since he was not required to file Montana returns prior to tax year 1994, it would be improper and contrary to statute to go back and show expenses that were not related to the year that he's filing because he's a cash-basis taxpayer who is reporting income, losses and deductions in the year that he's filing. Since the taxpayers were not required to file Montana returns prior to 1994, they fail to meet the first prong of the test. The deductions were not taken in Montana. The taxpayers also fail to meet the second prong of the text. Those deductions did not reduce his tax obligation in the state of Montana.

The DOR points out that it was only after the Loflins became Montana residents in 1996 that the capital gain from the sale of the Roney Plaza Associates partnership was reported, and subsequently sought to be reduced on an amended return as a result of losses incurred during those years when they were not state residents and were not subject to Montana income tax liability.

The DOR asserts that the legislature did not intend to sanction such an inequity that would exist should the taxpayers be allowed to "import" losses from other jurisdictions in previous years, as they are attempting to do in the present case.

## BOARD DISCUSSION

Both parties acknowledged that the DOR has used a two-prong test in applying the tax benefit rule under 15-30-111 (2) (k), MCA: 1) the item must have been deducted in a prior year and, 2) the deduction must have benefited the taxpayer by reducing his Montana income tax liability. The record before this Board does not indicate that the items previously deducted by the taxpayers in prior years on their federal income tax returns reduced their Montana liability. The taxpayers have also failed to satisfactorily demonstrate that the phrase found in Section 15-30-111 (2) (k), MCA, "any amount deducted in any prior tax year" includes federal income tax deductions claimed by them in previous years since that portion of the statute also specifies "to the extent that the recovered amount did not reduce the taxpayer's Montana income tax in the year deducted." A deduction taken on a federal return by a non-resident during a year when no Montana filing was required will not meet the second prong of the tax benefit rule. The Board finds the language of the above statute to be clear and unambiguous in this matter.

The taxpayers assert that it would be impossible for the deduction to have benefited them in Montana because, as non-residents, they were not required to file Montana

returns during such years. The Board does not believe the legislative intent was to penalize persons who have paid state income taxes in a prior year while providing a double tax exemption to persons who had not been Montana income taxpayers. Exemptions and deductions are a matter of legislative grace. If the legislature is going to grant an exemption or a deduction against income, it must be granted **explicitly**. No legislative history or intent has been offered other than the taxpayers' interpretation of the statute to support their view.

At the hearing before this Board, the taxpayer acknowledged that money is due to some state, probably South Carolina. The Board finds merit in the suggested course of action by both the DOR hearing examiner and the revenue agent testifying at the hearing before this Board. Montana offers a credit against taxes due in other states. (15-30-124) The taxpayer was advised to file the New York and South Caroline returns, incur and pay the tax liability on the capital gain and then amend the Montana return again to take the credits for taxes paid to another state.

It is this Board's conclusion that, in accordance with Section 15-30-111 (2) (k), the two prongs must go hand-in-hand in interpretation of the tax benefit rule: the filing of the return, the taking of the deduction or

expense and the subsequent benefit from the expense or deduction. If a taxpayer recoups an amount that was deducted in a previous tax year in Montana, the taxpayer is required to report the recovered amount as income to the extent that the amount did reduce the taxpayer's Montana income tax liability.

The Board gives deference to the DOR's interpretation of Section 15-30-111 (2) (k), MCA., a statute it is charged with enforcing. (Christenot v. State, 272 Mont. 396, 401, 901 P.2d 545 (1995) and Pletcher v. Montana Department of Revenue, 280 Mont. 419, 422-23,930 P.2d 656 (1996).

CONCLUSIONS OF LAW

1. The Board has jurisdiction in this matter pursuant to Section 15-2-201 (d), MCA.

2. The controlling statute in this matter is Section 15-30-111 (2) (k), MCA, (as cited in 1995 law before amended by 1997 legislative session). The DOR has properly demonstrated that it acted in accordance with statute in this matter.

3. The appeal of the taxpayers is hereby denied and the decision of the Department of Revenue is hereby affirmed. The denial of the refund claim at issue is affirmed.

ORDER

IT IS THEREFORE ORDERED by the State Tax Appeal Board of the State of Montana that denial of the refund claim at issue is affirmed.

Dated this 27th of September, 1999.

BY ORDER OF THE
STATE TAX APPEAL BOARD

( S E A L )

_____
GREGORY A. THORNQUIST, Chairman

_____
JAN BROWN, Member

_____
JERE ANN NELSON, Member

NOTICE: You are entitled to judicial review of this Order in accordance with Section 15-2-303(2), MCA. Judicial review may be obtained by filing a petition in district court within 60 days following the service of this Order.

CERTIFICATE OF SERVICE

The undersigned hereby certifies that on this 27th day of September, 1999, a true and correct copy of the foregoing has been served on the parties hereto by depositing a copy thereof in the U.S. Mails, postage prepaid, addressed to the parties as follows:

W. Scott Green
Attorney at Law
WEST, PATTEN, BEKKEDAHL & GREEN, P.L.L.C.
Suite 100, Old Chamber Building
301 North 27th Street
Billings, Montana 59101

Brenda Gilmer
Tax Counsel
Office of Legal Affairs
Department of Revenue
Sam Mitchell Building
Helena, Montana 59620

_____
Donna Eubank
Paralegal